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The Importance of the Insurance Sector for the Economic Development in Ukraine: Analysis and Policy Recommendations[1]

Executive Summary

The existence of a healthy insurance sector is an important condition for the well being of the population and for sustainable economic growth. In Ukraine, the insurance industry is in a very premature stage of development and faces several problems. Consequently, the development of this sector should become a priority of governmental economic and social policy. In order to achieve this goal, we put forward three sets of recommendations. First, the supervisory body for insurance activity (the "State Commission") should be provided by the government and by the insurance companies with significantly higher financial resources in order to be able to fulfill its extremely important job in a proper way. Second, consumer protection should be improved through the creation of a neutral arbitrator (Ombudsman). Third, the existing compulsory motor third party liability insurance should be implemented more effectively. This will increase the protection of potential victims and will act as a driving force for the further development of the insurance industry as a whole.

Content:

[1] This paper was produced in collaboration with Volker Henke from the GDV - German Insurance Association.

1. Risks and Insurance

Individuals, enterprises and society as a whole are confronted with a diversity of *risks*, such as illness, car accidents, damage to property, damage to crops or the interruption of the production process. The existence of economic risks is a source of discomfort and of economic insecurity and uncertainty. Unexpected and unintended events do not only cause direct losses such as machine damage through fire, but also significant indirect losses e.g. if damage results in business interruption. A loss-affected company might not recover and go bankrupt - causing additional difficulties (losses) for its clients and suppliers.

Risk however can be managed. Government policy (regulation, supervision) has a crucial influence on the absolute level of risk in a society and the way it is managed. Government can help to *avoid* risks - for example by prohibiting dangerous production processes. Furthermore it can also help to *prevent and reduce losses* associated to risks such as personal accidents by establishing a proper traffic guidance system (traffic lights) and by forcing companies to guarantee safe working conditions. Such measures contribute to the reduction of the frequency and severity of losses, and thus to the economic well being of society.

Although risks can be significantly reduced through individual and governmental efforts, it is impossible and not desirable to completely eliminate risks. The best way to deal with the residual risks in a society is through *insurance*[2]. By purchasing an insurance policy, individuals can transfer risks from their family or organization to the insurer. The financial burden of the unfortunate few who suffer losses are indemnified from a pool, i.e. from the funds collected from all potential claimants (policyholders). In addition, insurance allows encountering inevitable risks associated with investment projects, which people could or should otherwise not bear. Encountering these prevalent risks of business and investment decisions is decisive for the innovation, development and economic growth of an economy.

2. The Economic and Social Importance of Insurance

In this part we show why a healthy insurance industry is of crucial importance for the welfare and for the development of a country. The benefits of a functioning insurance market are huge and they reach all groups and sectors of the economy. But also the costs of insurance should be taken into account.

(i) Benefits of Insurance

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[2] In this paper we refer to insurance as non-social insurance through companies operating on the market. The role of governmental social insurance schemes will be intentionally left aside to avoid unnecessary complexity and keep a straightforward focus on the commercial insurance market.

The insurance mechanism is an essential method to handle and control risk in a rational and sophisticated way. Insurance enables people to choose which risks they take and which they protect themselves against. An efficient insurance industry provides important and unique benefits for households, enterprises, commerce, government, and the financial sector.

Private households benefit through personal lines of insurance such as life, health or property insurance. Insurance can enable a higher quality of life by satisfying the universal desire for security and guaranteeing an assured level of income. Compulsory insurance such as motor liability insurance establishes an indispensable system of social protection. It can protect potential victims against the insolvency of injurers. Insurances quantify the consequences of risk-taking behaviour by setting insurance premiums according to individual risk (risk pricing). This allows insured people to deal more rationally with risks and can prevent them from unreasonably risky actions/decisions. Individuals have strong economic incentives to reduce their risks and control loss potentials. Automobile drivers are encouraged to prevent accidents and improve their car's safety conditions to avoid higher insurance premiums. Furthermore insurance companies have an interest themselves to help their clients prevent and reduce losses. They are likely to promote a variety of preventive measures (safer cars or production) and introduce loss control programmes.

Insurance promotes and stabilizes *entrepreneurship, production and commerce*. Many products and services are produced and sold only if adequate insurance is available. Entrepreneurs are much more likely to invest in innovative ventures if they can secure adequate insurance protection. E.g. a pharmaceutical company is unlikely to develop and market a highly beneficial product without access to product liability insurance. Accordingly, insurance allows industry managers to encounter the risk of damage to production facilities, which will increase their willingness to invest in them.[3] Besides, insurance enhances the credibility of economic agents. Trade and commerce are facilitated when transportation, payment and goods are insured. Consumers on the other hand are encouraged to purchase large-expense items, such as automobiles or real estate. Insurance consequently serves as a "lubricant of commerce" fostering consumption, entrepreneurship and innovation. Likewise property/liability insurers can reduce costly interruption or even the entire liquidation of firms in case of unforeseen losses. They can minimize follow-up costs of financial distress. This helps to avoid substantial capital waste and stabilizes business and the economy as a whole.

Insurances can help to reduce *government spending* significantly. Insurers can in part substitute for government security programs (such as insurance against premature death or disability). They relieve pressure on social welfare systems, reserving government resources for essential social security purposes.

[3] Besides, insurance of machines and production facilities is a common precondition for their usage as collateral for bank credits.

Moreover, insurance can cushion negative economic effects of natural calamities (such as crop loss) reducing the need for financial firefighting interventions by the state.

Finally, insurance markets play a crucial role for the development and efficient functioning of the *financial sector*. Insurance companies are financial intermediaries. They reduce transaction costs from savers to borrowers by amassing large sums from thousands of small premium payers. Life insurers help to mobilize and channel significant amounts of savings to investments in corporate and government bonds, commercial mortgages and equity. World-wide, life insurers have become a key source of long-term finance, which is particularly important for emerging economies in need of investment for infrastructure projects.

Summarising, an efficient insurance market is likely to:

- Considerably reduce the amount of risk and losses and increase risk awareness
- Enable a higher quality of life, ensure social protection and relieve the public sector
- Promote commerce and entrepreneurship and stabilize the economy
- Foster capital mobilization and its efficient investment through financial markets

(ii) Costs of Insurance

Although insurance provides enormous benefits its *economic and social costs* can be great and have to be taken seriously. First of all, insurers tie economic resources and cause sales and administrative expenses. Additionally, insurance coverage can incite dishonest and incautious behaviour (moral hazard). The assured financial indemnification can result in fraudulent or inflated claims and an inappropriately lax attitude towards potential losses. Auto accidents for instance may be faked or damage may be overstated to collect benefits from the insurance companies. There may also be significant potential social and economic costs if regulation and surveillance of insurance companies is insufficient: Without a strong regulatory and competitive framework policyholders would not be protected against the insolvency or unscrupulous behaviour of insurance companies. They would be unable to enforce their rights and might be strained to pay overly high premiums. Insurance could also be misused for criminal purposes such as money laundering, tax evasion or illegal self-enrichment.

(iii) Net Effect of Insurance: Costs vs. Benefits

Taken together the social and economic benefits of insurance generally outweigh its potential costs by far. It is however the responsibility of the government to ensure that this precondition is guaranteed. Only an appropriate regulatory and legal framework with proper surveillance will allow to *control and minimize the costs of insurance*.

3. The Insurance Market in Ukraine

The Ukrainian insurance market is increasing both in size and sophistication. There has been above average yearly growth of 42% in premium income over the last three years[4] and much has been done in terms of legislation and regulation to foster its positive advancement. Despite this promising development, the insurance market still remains vastly under-developed and there is a strong need for further improvement.

(i) The Ukrainian Economy is Under-Insured

By international standards, the insurance industry in Ukraine is still very small. As table 1 illustrates, insurance expenditure per capita (insurance density) amounted to a mere USD 17.1 in 2002, which is considerably lower than the corresponding figures for other transition countries such as Poland and Bulgaria.

Table 1: Insurance Indicators in Selected Countries:

Country	Insurance Density	Insurance Penetration	
	Premiums per capita (USD, 2002)	Non-Life Insurance: Premiums (% of GDP, 2002)	Life Insurance: Premiums (% of GDP, 2002)
Japan	3498.6 USD	2.22%	8.64%
United States	3461.6 USD	4.98%	4.60%
Denmark	2448.3 USD	2.68%	4.84%
Germany	1627.7 USD	3.70%	3.06%
South Korea	1159.8 USD	3.38%	8.23%
Spain	1091.5 USD	3.12%	3.65%
Malaysia	198.0 USD	1.97%	2.94%
Slovakia	148.8 USD	1.92%	1.46%
Poland	144.5 USD	1.92%	1.04%
Russia	66.6 USD	1.81%	0.96%
Bulgaria	43.1 USD	1.47%	0.44%
Ukraine	**17.1 USD**	**2.00%**	**0.01%**

Source: Swiss Re (Sigma): World Insurance in 2002 (published November 2003)

Nominal insurance penetration (total premiums to GDP) of the non-life sector appears to be quite high at first glance (2% in 2002), exceeding countries like Slovakia or Malaysia. Yet a look behind the numbers reveals that an exceptionally large part of the Ukrainian premium volume can be associated to *pseudo insurance activity*. Insurance in Ukraine is often used as a vehicle for tax

[4] See Benfield's "Ukraine Insurance Market Review", June 2003. Available at: http://www.benfieldgroup.com/research/reports/industry+analysis+and+market+review/ukraine0603.pdf

avoidance, for illegal capital export and for intra-group financial engineering.[5] Experts estimate that up to 80% of the market can be attributed to pseudo and black market activities.[6] While such activities have been widespread in many transition economies[7], their estimated present degree in Ukraine as in Russia is particularly high. Despite a promising growth in 'real' insurance (i.e. insurance not attributed to tax avoidance or capital export) estimated at 30% in 2002[8], there are still only few insurance companies in Ukraine that transact business on a sound basis. In sum, the 'real' penetration rate of non-life insurance is much lower then shown by official figures and certainly well below that of most other Eastern European countries.

In contrast to non-life insurance, life insurance in Ukraine is still in its infancy. The life premium income of about USD 3 m in 2002 represents just 0.5% of total premiums, while in many Western countries it comprises more than 60%.[9] Accordingly, life insurance penetration is only 0.01% (see Table 1), a tiny figure compared to 3.06% in Germany or 1.04% in Poland.

The comparatively low development of insurance in Ukraine can be also be demonstrated by taking a closer view at the patterns of insurance coverage. According to market experts, only 10% of risks in Ukraine are presently insured. In comparison, risk coverage in most developed countries commonly surpasses 90%.[10] Elementary insurance classes, such as motor and fire insurance are under-developed. Motor third party liability (MTPL) insurance both for bodily injury and property damage is already obligatory but enforcement is extremely limited and minimum levels of coverage are too low. Reportedly, only 10-20% of the circulating 10 million vehicles are insured compared to 80% in Belarus, 94% in Poland and 99% in Germany.

(ii) Characteristics of the Insurance Market

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[5] Insurance companies are often part of a financial group and function mainly as captive insurers. Many companies have been set up to take advantage of the 3% tax regime for insurance premiums to avoid the 30% tax on enterprise profits. "Typically one of these 'pocket' insurance companies will issue a policy to its shareholder for a large premium involving no risk. The insurer can then grant a beneficial loan to their shareholder or use reinsurance to export capital abroad." (Axco Insurance Market Report on Ukraine - Non Life, December 2003).

[6] See "Axco Insurance Market Report on Ukraine - Non Life", December 2003 and Benfield's "Ukraine Insurance Market Review", June 2003. Available at: http://www.benfieldgroup.com/research/reports/industry+analysis+and+market+review/ukraine0603.pdf

[7] Such activities tend to be high in countries with small and young insurance markets and tend to gradually decrease with market development.

[8] See "Axco Insurance Market Report on Ukraine - Non Life", December 2003.

[9] See Benfield's "Ukraine Insurance Market Review", June 2003. Available at: http://www.benfieldgroup.com/research/reports/industry+analysis+and+market+review/ukraine0603.pdf The low proportion of life to non-life premiums is a feature of many Eastern European countries in transition.

[10] See Benfield's "Ukraine Insurance Market Review", June 2003. Available at: http://www.benfieldgroup.com/research/reports/industry+analysis+and+market+review/ukraine0603.pdf

The market is mostly operating on a business-to-business level. There is a strong *concentration on commercial and industrial property insurance*, accounting for 76.9% of total premiums in 2002.[11] Coverage is mostly purchased by foreign investors and by major international corporations doing business in Ukraine. In turn, private lines of insurance are fairly undeveloped. Ukraine has a low level of insurance culture and companies invest little into educative marketing and retail activities. As a result, large parts of the population still remain unaware of the concept and benefits of insurance.

The *regulatory and institutional framework* of the insurance market has been considerably improved. In 2003 insurance supervision was transferred from the Ministry of Finance to the *State Commission for Regulation of Financial Services Markets* (short: State Commission). The State Commission was entrusted with important legal powers to ensure essential regulatory and supervisory duties in the insurance market (such as the provision and withdrawal of licenses, the assurance of solvency and capital requirements and the inhibition of grey market activity). The central and departmental bodies of the State Commission are financed exclusively from the state budget. Public expectations towards the State Commission are high and its chairman Mr. Suslov is a well-reputed professional. Regrettably, the allocated budget and technical provisions are definitely inadequate. The salary base of the State Commission is far too low to attract enough qualified insurance professionals especially when compared to salaries paid by insurance companies. In addition, market insiders question whether the State Commission will have enough politically backed powers, e.g. to effectively eliminate pseudo insurance companies from the market.

Consumer protection in Ukraine's insurance system is not satisfactory. There are serious concerns in the following three fields: Insurance law, insurance dispute resolution and the circumstances insurances are sold. Although much has been done to improve the legal framework, there are still many deficits in insurance contract law in Ukraine. Some legal concepts are poorly defined and there are overlaps between the different laws related to insurance. In general, policyholders are mostly unaware of their rights and often unable to enforce them. The civil court system is supposed to resolve all insurance disputes. Courts however are overloaded, slow and inexperienced in handling insurance related litigation. It is often difficult to predict and understand how decisions are made. Nonetheless there are no alternative institutions of dispute resolution such as an insurance Ombudsman. Insurance agents are the most important distribution channels of insurance companies. In contrast to insurance brokers, agents are neither subject to registration nor to supervision. As agents do not need to be licensed, their qualification and reliability varies strongly. Consequently, policyholders as well as those seeking insurance are often not sufficiently protected from precarious conduct and advice.

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[11] See Benfield's "Ukraine Insurance Market Review", June 2003. Available at: http://www.benfieldgroup.com/research/reports/industry+analysis+and+market+review/ukraine0603.pdf

4. Policy recommendations

As the market analysis shows, risk management in Ukraine is far from ideal. Presently, most risks in Ukraine's society are not insured at all. Many necessary steps to transform the insurance industry in accord to international standards are yet to be taken. However, recent development in Ukrainian markets and regulation give good reason for optimism. With a population of 48 million and a growing economy, market opportunities for insurance companies are huge. Improved risk control and insurance can become a major generator of development and economic growth in Ukraine.

In our view, an increase in the level of insurance and the development of a well functioning insurance market should become a priority of governmental economic and social policy. The transition towards sizeable and efficient insurance markets is long-winded and will certainly not come overnight. Instead, many legislative and regulatory steps and ongoing adoption will be necessary. At this point, the government should set realistic priorities and focus on a few crucial measures. We think that these priorities should be threefold: The support of the State Commission; the enhancement of consumer protection via legislation and an Ombudsman institution; and the enforcement of compulsory motor third party liability insurance.

(i) Insurance Supervision: More Support of the State Commission

An effective supervision is of imperative importance for the functioning and development of solvent and efficient insurance markets. This is especially the case in Ukraine where insurance tradition and confidence in financial markets are low. Supervision can ensure that insurance companies are financially viable, operating within the laws and offering insurance policy products at fair and adequate rates. Is this not the case, the societal costs of insurance markets may exceed the benefits. In Ukraine, the State Commission for Regulation of Financial Services Markets has been assigned with the necessary legal powers to effectively supervise the insurance market. However, it lacks the economical and political support to do so in an appropriate way. The young and inexperienced body is confronted with the enormous challenge to exert its supervisory assignments in a difficult environment and to put into practice the long list of statutory provisions of insurance regulation. It is indispensable to enable its directors to hire and train highly skilled and specialised professionals at a competitive salary and to perform their tasks with sufficient resources. We therefore strongly recommend providing the State Commission with proper funds as well as technical assistance as soon as possible. Apart from a considerable rise of governmental grants to the State Commission, we propose the introduction of a charge paid by the surveyed insurance companies themselves as is the case in Germany. Insurers would have to pay a regular amount related to their market share, which will be transferred to the State Commission. As the companies ultimately benefit from accurate market supervision, such a system has proved to be successful world-wide. It should however be guaranteed, that the charges paid by insurers are not too high; e.g.

by setting an upper limit in percent of total premiums. In addition, the failure or success of the State Commission will strongly depend on its political support. Especially in its early years of existence it is crucial that government backs the work and authority of the State Commission.[12]

(ii) Consumer Protection: Creation of an Insurance Ombudsman and Licensing of Agents

In order to improve consumer protection, we recommend the creation of an institution for insurance related litigation. Such an "Insurance Ombudsman" will permit to resolve conflicts between policyholders and insurers avoiding a legal process. The Ombudsman as a neutral arbitrator could be authorised to resolve conflicts up to a certain amount in dispute. While its decisions will generally be binding upon insurance companies, policyholders may keep the option to take further legal action. Such an arrangement primarily protects the interests of the weakest market participants – insurance consumers. However, most insurance companies also have a strong interest to avoid lengthy and costly court procedures and will certainly benefit from higher trustworthiness of their services. The Ombudsman model is an attractive alternative for dispute resolution, which has proved of value in many countries such as Germany, the U.S. or in Scandinavia. In Ukraine, an Insurance Ombudsman would help to relieve the court system as well as the State Commission. Furthermore, it would certainly contribute to a great extent to build up necessary confidence in the insurance market.

Furthermore, government should address the qualification and seriousness of insurance agents. Only licensed and qualified agents should have the right to sell insurances. We recommend to delegate the task of registering and controlling Ukraine's insurance agents to an insurance association such as the League of Insurance Organizations in Ukraine in coordination with the State Commission.

(iii) Promoting the Market: Enforcement of Compulsory Motor Insurance

Motor insurance in Ukraine has developed very slowly. Motor third party liability (MTPL) insurance has been made compulsory in 1997. But unfortunately, no sanctions are foreseen for non-compliance. As a consequence, the compulsory character of this insurance exists only on paper. Yet MTPL insurance in road traffic is extremely important for the protection of potential victims. Without enforced insurance, innocent accident victims will not to be sufficiently indemnified for the damage and losses suffered. Experience has shown that compulsory MTPL insurance has been a motor of premium growth and market development in many emerging countries. In China and South Korea, car

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[12] A first test will be the enforcement of increased capital requirements established by the "Law of Ukraine on Insurance" in 2001, which insurers should implement by November 2003. As most operating insurance companies lack of sufficient financial strength, a successful enforcement of the new requirements is of crucial importance for avoiding further insolvencies and for promoting a much desirable consolidation of the market.

insurance accounts for more than 50% of the total market. In Ukraine, the potential size of the motor insurance market, when compulsory MTPL is fully enforced, is estimated at USD 170 m compared to USD 9.85 m in 2001.[13] Experiences with general car insurance can educate potential consumers and will expose them to other insurance services. Compulsory and voluntary car insurance is a suitable insurance product to propel the market forward and improve risk management for Ukraine's citizens in everyday life. No driver without insurance coverage should be allowed to circulate on public roads. We strongly recommend improving the legal and organisational environment for proper enforcement of the MTPL insurance. The draft of the new law on compulsory MTPL is promising as it foresees the introduction of a fine payable by drivers in the absence of compulsory insurance. But additional new legislation and a better coordination between all relevant actors including insurance companies, traffic police, judiciary institutions and damage surveyors will be necessary for enforcement to be really effective. The League of Insurance Organizations in Ukraine or another qualified insurance association should perform the task to establish and maintain a valid statistical database for the insurance market. Good data will be essential for the sound calculation of tariffs and perils of MTPL insurance and other key insurance classes.

5. Conclusions

A strong and healthy insurance sector is of utmost importance for all groups and sectors of the economy. Health, life and motor third party liability insurance enable private households to obtain a higher quality of life by satisfying their desire for security and for a guaranteed income level. Transport, product liability and property insurance promote entrepreneurial activities and commerce. Insurances against premature death or disability in part substitute governmental social spending and safes governmental resources for other essential social purposes. Life insurance promotes the development of capital markets and of the financial sector as a whole by creating a demand for long-term financial assets. Consequently, insurance should not be seen as a luxury good for rich countries, but as a necessary condition for sustainable economic growth in any country.

Ukraine's insurance sector is vastly under-developed and faces several problems. First, its supervisory body (the "State Commission") lacks the financial resources to fulfill its functions effectively. This is quite an alarming situation, given that supervision is particularly important in the first stages of development and that the opportunities for fraud and criminal activity are relatively high in this sector. One or two major cases of fraud would shed a negative light on the whole industry and hamper its development for many years to come. Second, consumer protection is poor. In particular, policyholders are often not able to enforce their rights, because courts are overloaded, slow and inexperienced in handling insurance related litigation. Third, the vast

[13] See "Axco Insurance Market Report on Ukraine - Non Life", December 2003.

majority of car drivers do not hold motor third party liability insurances. This leaves many victims of car accidents with no protection at all.

Taking into consideration the importance of a healthy insurance sector for the economic prosperity and the rather poor state of the Ukrainian insurance industry, we conclude that the Ukrainian government should consider the further development of this sector as a major priority of its economic and social policy. In order to promote the insurance sector, we recommend *three main sets of measures*. First, the State Commission has to be provided with much higher financial resources from the government and from insurance companies. Second, in order to improve consumer protection, to alleviate the courts and to gain the trust of the population, a neutral arbitrator (Ombudsman) should be created. Third, the motor third party liability insurance should become compulsory not only in paper, but also in practice. This is indispensable for the protection of potential victims. Besides, the expansion of car insurance will serve, as in many other countries, as the motor for the further development of the insurance industry as a whole.

In addition to these measures, important tasks should be delegated to insurance associations such as the League of Insurance Organizations in Ukraine. In particular, they should be responsible for the licensing and control of insurance agents as well as for the provision of statistical data.

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